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SEC Issues Concept Release On Regulation S-K- Part 1

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On April 15, 2016, the SEC issued a 341-page concept release and request for public comment on sweeping changes to certain business and financial disclosure requirements in Regulation S-K ("S-K Concept Release"). This blog is the first part in a series discussing that concept release. The S-K Concept Release is part of the SEC Disclosure Effectiveness Initiative mandated by the JOBS Act.

The fundamental tenet of the federal securities laws is defined by one word: disclosure. In fact, the SEC neither reviews nor opines on the merits of any company or transaction, but only upon the appropriate disclosure, including risks, made by that company.

This is the first blog in a two-part series on the S-K Concept Release. In this Part I, I will discuss the background and general concepts for which the SEC provides discussion and seeks comment. In Part II of the series I will discuss the rules and recommendations made by the SEC and, in particular, those related to the 100, 200, 300, 500 and 700 series of Regulation S-K.

Background

The topic of disclosure requirements under Regulation S-K as pertains to disclosures made in reports and registration statements filed under the Exchange Act of 1934 ("Exchange Act") and Securities Act of 1933 ("Securities Act") have come to the forefront over the past couple of years. Regulation S-K, as amended over the years, was adopted as part of a uniform disclosure initiative to provide a single regulatory source related to non-financial statement disclosures and information required to be included in registration statements and reports filed under the Exchange Act and the Securities Act. Regulation S-K has gone through many changes and amendments over the years, the full history of which is beyond the scope of this blog, but is laid out in great detail in the S-K Concept Release.

A public company with a class of securities registered under either Section 12 or which is subject to Section 15(d) of the Exchange Act must file reports with the SEC ("Reporting Requirements"). The underlying basis of the Reporting Requirements is to keep shareholders and the markets informed on a regular basis in a transparent manner. Reports filed with the SEC can be viewed by the public on the SEC EDGAR website. The required reports include an annual Form 10-K, quarterly Form 10Q's and current periodic Form 8-K, as well as proxy reports and certain shareholder and affiliate reporting requirements.

A company becomes subject to the Reporting Requirements by filing an Exchange Act Section 12 registration statement on either Form 10 or Form 8-A. A Section 12 registration statement may be filed voluntarily or per statutory requirement if the issuer's securities are held by either (i) 2,000 persons or (ii) 500 persons who are not accredited investors and where the issuer's total assets exceed $10 million. In addition, companies that file a registration statement under the Securities Act, such as a Form S-1, become subject to Reporting Requirement; however, such obligation becomes voluntary in any fiscal year at the beginning of which the company has fewer than 300 shareholders.

A reporting company also has record-keeping requirements, must implement internal accounting controls and is subject to the Sarbanes-Oxley Act of 2002, including the CEO/CFO certification requirements. Under the CEO/CFO certification requirement, the CEO and CFO must personally certify the content of the reports filed with the SEC and the procedures established by the issuer to report disclosures and prepare financial statements. For more information on that topic, see my blog HERE.

The S-K Concept Release discusses and seeks public comment on sweeping changes to certain business and financial disclosure requirements in Regulation S-K. The concept release does not address disclosures related to executive compensation and governance, which have also had sweeping changes over the past few years. In particular, the SEC has adopted pay ratio disclosure rules (see HERE); "pay vs. performance" rules, which I discussed in my blog HERE and "say on pay" advisory vote rules, which are discussed HERE.

The S-K Concept Release specifically discusses and seeks comment on:

Whether specific disclosures are important and useful to making investment and voting decisions and whether more, less or different information is needed;

Whether revisions to current requirements could enhance information provided and promote efficiency, competition, and capital formation;

Whether revisions could enhance investor protections;

Whether current requirements properly balance the costs and benefits of required disclosures;

Whether changes could lower costs by utilizing advancements in technology and communications;

Whether access to disclosure could be improved by modernizing methods used to present, aggregate and disseminate information; and

Challenges with the current disclosure regime.

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In addition, the S-K Concept Release discusses and seeks comment on the best way to implement changes, such as through temporary rules and sunset provisions which have a waterfall implementation schedule.

Introduction to the S-K Concept Release

As the S-K Concept Release is exactly as described—a "concept release" and not a rule-making release—it contains extensive discussion on the disclosure regime concepts. Logic dictates that in order to properly evaluate the efficacy of any changes to Regulation S-K, one must understand the concepts behind and purposes of the disclosure laws.

At the highest level, the purpose of disclosure is to provide investors and the marketplace with information needed to make informed investment and voting decisions. As discussed in the S-K Concept Release, proper disclosure "may lead to more accurate share prices, discourage fraud, heighten monitoring of the managers of companies, and increase liquidity." Further, effective disclosure should "increase the integrity of securities markets, build investor confidence, and support the provision of capital to the market."

However, the requirements must be balanced against the costs to the company making the disclosure, including issues with disclosing sensitive trade secret information to competitors. To address confidentiality concerns the SEC has adopted rules and regulations to request confidential treatment for certain information. Moreover, excessive rote immaterial disclosure can dilute the material important information regarding that particular company and have the unintended consequence of weakening necessary disclosure to potential investors and the public trading markets.

To add to the complicated issue, the disclosure requirements must consider the different types and size of public companies. Smaller companies cannot bear the same disclosure expense as larger entities, nor should they be required to. Smaller companies tend to have less complicated operations and business models and can fully explain these operations in a simplified manner.

Furthermore, the disclosure laws must consider the audience. In particular, investors, potential investors, and shareholders will use and analyze information differently from analysts, financial advisors and market makers. Investment bankers preparing for an IPO, analysts and institutional investors tend to prefer standardized information in machine-readable format that can be easily correlated and compared.

The disclosure laws, and the SEC discussion, understand that the cornerstone of the system must be materiality. In general, the rules rely on company management to evaluate and assess the necessary information to be included in registration and reports. This requirement is referred to as a "principles-based" approach because "they articulate a disclosure objective and look to management to exercise judgment in satisfying this objective."

Although materiality is the overriding concept, the disclosure laws also include certain prescriptive bright line information that must be included regardless of management's assessment of materiality. For example, the issuances of unregistered securities must be disclosed, regardless of materiality. The prescriptive rules are necessary for some information to ensure consistency, completeness and comparability across companies. Clearly there are circumstances where a prescriptive approach is helpful without a materiality assessment; the challenge becomes determining which disclosures should fall within which standard.

Materiality

Materiality is a fundamental concept throughout the federal securities laws, and one I have written about on many occasions. The disclosure requirements at the heart of the federal securities laws involve a delicate and complex balancing act. Too little information provides an inadequate basis for investment decisions; too much can muddle and diffuse disclosure and thereby lessen its usefulness. The legal concept of materiality provides the dividing line between what information companies must disclose, and must disclose correctly, and everything else. Materiality, however, is a highly subjective standard, often colored by a variety of factual presumptions.

The guiding purpose of the many and complex disclosure provisions of the federal securities laws is to promote "transparency" in the financial markets. However, the task of winnowing out the irrelevant, redundant and trivial from the potentially meaningful material falls on corporate executives and their professional advisors in the creation of corporate disclosure, and on investment advisors, stock analysts and individual investors in its interpretation. The concept of materiality represents the dividing line between information reasonably likely to influence investment decisions and everything else.

Only those misstatements and omissions that are material violate many provisions of the securities laws, including the bedrock provisions requiring accurate financial reporting. In 1976, the U.S. Supreme Court set the standard for a materiality evaluation, which standard remains today. In TSC Industries, Inc. v. Northway, Inc., the Supreme Court held that information should be deemed material if there exists a substantial likelihood that it would have been viewed by the reasonable investor as having significantly altered the total mix of information available to the public.

Despite this standard, the concept remains fact-driven and difficult to apply. There are no numeric thresholds to establish materiality, and market reaction is inconsistent and not always available. Ultimately professionals and company management must consider all facts and circumstances available to them on any given day to determine the materiality of a given disclosure in light of the standard established by the Supreme Court in TSC Industries.

Generally, professionals and company management must look in the first instance at specific disclosure guidelines set out in the federal securities rules and regulations (such as Regulations S-X and S-K and Forms 10-Q, 10-K and 8-K). Second, professionals and company management must consider all facts presently affecting the company. For instance, a specific disclosure may be highly relevant in light of current economic conditions and of little importance in a different economic climate. Ethical issues are generally not considered material, unless specifically required by statute (such as the Foreign Corrupt Practices Act).

Scaled Disclosure

The SEC disclosure requirements are scaled based on company size. For example, a "smaller reporting company" is defined as one that, among other things, has a public float of less than $75 million in common equity, or if unable to calculate the public float, has less than $50 million in annual revenues. The JOBS Act, enacted on April 5, 2012, created a new category of company called an "emerging growth company" for which certain scaled-down disclosure requirements apply for up to 5 years after an initial IPO. An emerging growth company is one that has total annual gross revenues of less than $1 billion during its most recent completed fiscal year.

The scaled-down disclosures for smaller reporting companies and emerging growth companies include, among other items: (i) only 3 years of business description as opposed to 5; (ii) 2 years of financial statements as opposed to 3; (iii) elimination of certain line item disclosures such as certain graphs and selected financial data; and (iv) relief from the 404(b) auditor attestation requirements. However, although similar, there are differences between the scaled disclosure requirements for an emerging growth company vs. a smaller reporting company. In particular, the following chart summarizes these differences:

Scaled Disclosure Requirement	**Emerging Growth Company**	**Smaller Reporting Company**
Audited Financial Statements Required	• 2 years in a Securities Act registration statement for an IPO of common equity. • 3 years in an IPO of debt securities. • 3 years in an annual report or Exchange Act registration statement, unless the company is also an SRC.	• 2 years.

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Description of Business (Item 101)	Standard disclosure requirements apply.	• Development of its business during the most recent three years, including: o form and year of organization; o bankruptcy proceedings; o material reclassification, merger, sale or purchase of assets; and o description of the business. • Not required: o seasonality; o working capital practices; o backlog; or o government contracts. • Names of principal suppliers. • Royalty agreements or labor contracts. • Need for government approval of principal products and services. • Effect of existing or probable governmental regulations.
Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters (Item 201)	Standard disclosure requirements apply.	Not required to provide the stock performance graph.
Selected Financial Data (Item 301)	Not required to present selected financial data for any period prior to the earliest audited period presented in initial registration statement.	Not required.

Supplementary Financial Data (Item 302)	Not required until after IPO.	Not required.
MD&A (Item 303)	May limit discussion to those years for which audited financial statements are included.	• May limit discussion to those years for which audited financial statements are included. • Not required to comply with contractual obligations table requirements in 303(a)(5).
Quantitative and Qualitative Disclosures about Market Risk (Item 305)	Standard disclosure requirements apply.	Not required, but related disclosure may be required in MD&A.
Extended Transition for Complying with New or Revised Accounting Standards	• May elect to defer compliance with new or revised financial accounting standards until a company that is not an "issuer"[894] is required to comply with such standards. • Any decision to forego the extended transition period is irrevocable.	Standard disclosure requirements apply.
Internal Control over Financial Reporting (Item 308)	• Not required to provide attestation report of the registered public accounting firm. • Not exempt from Item 308(a), but newly public company is not required to comply until it either has filed or has been required to file an annual report for the prior fiscal year.	Non-accelerated filers, a category that includes SRCs, are not required to provide an attestation report of the registered public accounting firm.

Executive Compensation Disclosure (Item 402)	• Permitted to follow requirements for SRCs.[895]
	• Exempt from principal executive officer pay ratio disclosure.
		• 2 years of summary compensation table information, rather than 3.
		• Limited to principal executive officer, two most highly compensated executive officers and up to two additional individuals no longer serving as executive officers at year end.[896]
		• Not required:
		  ○ compensation discussion and analysis;
		  ○ grants of plan-based awards table;
		  ○ option exercises and stock vested table;
		  ○ change in present value of pension benefits;
		  ○ CEO pay ratio;
		  ○ compensation policies as related to risk management; or
		  ○ pension benefits table.
		• Description of retirement benefit plans.

Certain Relationships and Related Party Transactions (Item404)	Standard disclosure requirements apply.	• Lower threshold to disclose related party transactions. • Not required to disclose procedures for review, approval or ratification of related party transactions. • Additional requirement to disclose certain controlling entities. • Required to disclose related party transactions not only since the beginning of last fiscal year but also for the preceding fiscal year.
Corporate Governance (Item 407)	Standard disclosure requirements apply.	• Not required to disclose whether it has an audit committee financial expert until its second annual report following IPO. • Exempt from requirements to disclose compensation committee interlocks and insider participation and to provide a compensation committee report.
Risk Factors (Item503(c))	Standard disclosure requirements apply.	Not required in periodic reports.
Ratio of Earnings to Fixed Charges (Item 503(d))	Required for same number of years for which it provides selected financial data disclosures.	Not required.

The S-K Concept Release contains a very useful table summarizing the category of reporting company, and in particular:

CATEGORY OF FILER	PUBLIC FLOAT[1] TO ENTER STATUS	REVNEUES[2] TO ENTER STATUS	CRITERIA TO EXIT STATUS	PUBLIC FLOAT TO RE-ENTER STATUS	REVENUES TO RE-ENTER STATUS
Emerging Growth Company (EGC)	N/A	<$1 Billion	• Revenues >$1 billion • 5th anniversary of IPO[3] • Non-convertible debt > $1 billion • Float > $700 Million	N/A	N/A
Smaller Reporting Company	<$75 Million	<$50 Million[4]	Float > $75 Million	<$50 Million	<$40 Million
Non-Accelerated Filer	<$75 Million	N/A	Float > $75 Million	<$50 Million	N/A
Accelerated Filer	>$75 Million but <$700 Million	N/A	Float <$75 million or > $700 Million	<$500 Million but > $50 Million	N/A
Large Accelerated Filer	>$700 Million	N/A	Float <$700 Million	N/A	N/A

1 Public float is calculated as of the last business day of the company's most recently completed second fiscal quarter.

2 Revenues as reported in the company's most recently completed fiscal year

3 Ineligibility begins on last day of the fiscal year in which the 5th anniversary occurs.

4 Revenue test applies only if public float is zero.

The SEC discussed potential changes to the scaled requirements, including aligning the smaller reporting company and emerging growth company requirements. The SEC Advisory Committee on Small and Emerging Companies suggested that the SEC should revise the definition of "smaller reporting company" to include companies with a public float of up to $250 million. This will increase the class of companies benefitting from a broad range of benefits to smaller reporting companies, including (i) exemption from the pay ratio rule; (ii) exemption from the auditor attestation requirements; and (iii) exemption from providing a compensation discussion and analysis. In addition, the Committee suggested that the SEC should revise the definition of "accelerated filer" to include companies with a public float of $250 million or more but less than $700 million. As a result, the auditor attestation report under Section 404(b) of the Sarbanes Oxley Act would no longer apply to companies with a public float between $75 million and $250 million.

Although the SEC seeks public comment as to changes in the eligibility standards for each category, it does not make particular recommendations in the S-K Concept Release but rather indicates that it is currently evaluating the criteria.

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Particular Areas of Discussion

The S-K Concept Release drills down on the 100, 200, 300, 500 and 700 rule series of Regulation S-K. I will detail that discussion in Part II of this blog. In addition, the SEC touches on most other aspects of Regulation S-K and the federal securities laws and guidance related to disclosure. Below is a brief discussion of those areas, each of which the SEC requests comment on.

Industry Guides

The SEC has issued five industry guides to assist companies in those particular industries in formulating effective disclosures. The five guides include: (i) bank holding companies; (ii) oil and gas programs; (iii) real estate limited partnerships; (iv) property casualty insurance underwriters; and (v) mining companies. The SEC seeks comment and discussion on the usefulness of such guides.

Public Policy and Sustainability Matters

Over the years, the SEC has mandated disclosures related to public policy concerns. For example, there are rules related to disclosures on conflict minerals and resource extraction from foreign countries, environmental matters and other issues of social concern. The SEC seeks discussion and comment on the appropriateness of these requirements and whether they should be expanded or reduced.

Exhibits

Item 601 of Regulation S-K requires the filing of certain material contracts, corporate documents, and other information as exhibits to registration statements and reports. A particular area of discussion recently has been the need to file schedules to contracts. These schedules can be lengthy and lack materiality. Likewise, a recent area of discussion has been the necessity of filing an immaterial amendment to a material exhibit. The S-K Concept Release contains a lengthy discussion on Exhibits, including drilling down on specific filing requirements. Many of the exhibit filing requirements are principle-based, including, for example, quantitative thresholds for contracts. Consistent with the rest of the S-K Concept Release, the SEC discusses whether these principle-based, quantitative standards should be changed to the materiality approach. The SEC also discusses eliminating some exhibit filing requirements altogether, such as where the information is otherwise fleshed out in financial statements or other disclosures (for example, a list of subsidiaries).

Frequency of Interim Reporting

Currently the SEC Reporting Requirements require the filing of a quarterly Form 10-Q, annual 10-K and periodic Form 8-Ks. The S-K Concept Release discusses and seeks comment on the necessity of a quarterly Form 10-Q and whether it should be eliminated or made voluntary.

Presentation and Delivery of Important Information

The discussion on presentation and delivery of important information includes cross-referencing, incorporation by reference, and the use of hyperlinks both to and within SEC registration statements and reports, and outside of such filings such as to corporate websites.

Specific Formatting

The discussion of formatting discusses and seeks comment on whether the layout and presentation of information should be in accordance with a specific form or whether a company should be given wide latitude in that regard. Currently, Forms 10-K and 10-Q specifically state that they are not blank forms to be filled out but rather a guide in providing useful information.

XBRL Tagging

The S-K Concept Release discusses and seeks comment on the use and usefulness of XBRL tagging in general and across the scaled disclosure categories of companies. The SEC Advisory Committee on Small and Emerging Companies suggested that the SEC eliminate XBRL tagging for smaller reporting companies. I agree.

Further Background

Prior to the S-K Concept Release, in September 2015 the SEC Advisory Committee on Small and Emerging Companies met and finalized its recommendation to the SEC regarding changes to the disclosure requirements for smaller publicly traded companies.

In March 2015 the American Bar Association submitted its second comment letter to the SEC making recommendations for changes to Regulation S-K.

In early December 2014, the House passed the Disclosure Modernization and Simplification Act of 2014, following which it was bundled into the FAST Act and passed into law on December 4, 2015. The Disclosure Modernization and Simplification Act of 2014 requires the SEC to adopt or amend rules to: (i) allow issuers to include a summary page to Form 10-K; and (ii) scale or eliminate duplicative, antiquated or unnecessary requirements for emerging growth companies, accelerated filers, smaller reporting companies and other smaller issuers in Regulation S-K. In addition, the SEC is required to conduct a study within one year on all Regulation S-K disclosure requirements to determine how best to amend and modernize the rules to reduce costs and burdens while still providing all material information..

The FAST Act requests that the SEC emphasize a "company by company approach that allows relevant and material information to be disseminated to investors without boilerplate language or static requirements while preserving completeness and comparability of information across registrants" and "evaluate methods of information delivery and presentation and explore methods for discouraging repetition and the disclosure of immaterial information."

This approach is thought of as a principled approach with a concentration on materiality as opposed to just filling in line item information whether relevant or not to a particular company. It is believed, and I completely agree, that simply providing required line item disclosures, that are not relevant to a particular company, dilutes the material important information regarding that particular company and has the unintended consequence of weakening necessary disclosure to potential investors and the public trading markets.

Even before the FAST Act, in May 2015, General Electric filed its annual 10-K with a complete makeover from prior years. GE's 10-K, the first like it, is full of colorful charts and graphics and has scaled-down narrative from what was once a virtually incomprehensible document. GE worked with the SEC on the new 10-K utilizing the materiality approach.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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